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COSTA RICA
POLICY TOOLS FOR RURAL FINANCE

BANCO NACIONAL DE COSTA RICA: AGRICULTURAL LOAN PROCEDURES, PRACTICES AND PERFORMANCE

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I. Current Administrative Scenario:

The Banco Nacional de Costa Rica reflects a broad range of operational characteristics, that grows out of its long history of branch banking, its traditional role as the major supplier of small farmer credit in the country, and its bureaucratic style of centralized decision-making. Its overwhelming dominance in Costa Rica's financial markets and the lack of effective competition (until recently) have heavily influenced its legacy of excessive documentation. This legacy also consists of little consideration of risk in the management of its portfolio and the bank's readily accepted role as the government's main channel for development finance (especially in agriculture). In this setting, it is not surprising to note that the administrative procedures of loan evaluation, loan monitoring, and loan recovery carry a degree of documentation and supervision that adds substantially to bank costs.

To investigate these costs, visits were made to three branches (Turrialba, Guácimo, and Orotina) and extensive interviews were undertaken of officials in the Departamento de Crédito Rural, in Estudios Económicos, and the office coordinating donor funds (UNDICO). The results of these interviews, concerning the administrative procedures of dealing with the loan portfolio, can be summarized as follows:

1. Procedure: There is an extensive amount of paperwork associated with the loan applications, from 6 to 20 separate forms for standard short-term loans in the Juntas Rurales (depending upon enterprise type), and as much as 25 pages and 7 to 8 detailed tables for BID loans, administered through UNDICO (Unidad De Dirección y Coordinación), the unit of the Banco Nacional that handles donor funding for agricultural investment loans. The paperwork (from application to disbursement) for short-term loans takes 3 to 4 weeks, while for long-term investment loans through the BID program it can take from 6 to 8 weeks.

2. Borrower Eligibility: Among other things, this documentation is concerned with determining whether a farmer qualifies for a subsidized small farmer loan, at a 15 percent interest rate in the Junta Rural, or is only able to take out a commercial loan, at current market interest rates (around 22 or 23 percent). Up to early 1988, the eligibility threshold for the Junta Rural portfolio has been a gross income of 800,000 colones. Some delegados in the branch offices apparently feel they have been able to estimate this threshold with knowledge about the farm acreage, what crops are grown, and the ruling market prices (they ignore non-farm or off-farm income sources for the family). Other delegados have used the amount of accumulated outstanding debt as a proxy for determining small farmer eligibility. If outstanding debt fell below 800,000 colones, the farmer qual-

ified. No doubt, there has been an uneven application of this rule across the large number of branches. In early 1988, these gross income and debt thresholds have been raised to 900,000 colones.

3. Avíos: The heavy incidence of documentation, lies in the use of detailed farm budget models (avíos) for selected crops and enterprises, in order to determine the total costs of production of the prospective borrower. Branches are told not to lend more than the total costs of production estimated through these exercises. They are able to lend less. However, the maximum has in effect become the norm for a number of branches. In these branches, the full-cost lending practices reflect their tendency to treat all borrowers equally. This avoids the hassle of differential treatment (and the charge of favoritism) that could grow out of differential levels of self-finance they might build into the loan contracts.

The detailed BID long-term investment loans cover only 80 percent of the total cost of these projects. However, the remaining 20 percent is made up of family labor and other forms of farmer participation that do not require cash payments. In effect, this can imply that the bank engages in 100 percent of financing.

This BID financing is directed towards new, non-traditional export crops (in contrast to the more traditional crops financed through the Juntas Rurales) and is generally processed initially by the delegado at the branch level. However, in the Banco Nacional system there is a team of roughly 50 BID-trained professionals, headquartered in UNDICO. The team has 10 professionals in the San Jose office (supported by 20 clerical staff) and 10 teams of roughly 4 members each, spread throughout the country, for field level technical assistance for the farm-borrowers and the delegados. These teams consist of a veterinarian, two agronomists, and an animal scientist.

This team represents a substantial investment in human resources. To date, no cost-effective study of their activities has been undertaken or even proposed. BID presumably supports 50 percent of this expensive payroll and the Banco Nacional has absorbed the rest. It is not clear if this gradual absorption will continue by the Banco Nacional or whether its relative share of covering these costs will remain at this present level.

4. <u>UNDICO</u>: As stated above, approximately 50 professional technicians work in the BID-oriented unit of the bank, of which 14 were trained in foreign universities. They no doubt represent a valuable level of expertise, that should be able to make a contribution to a rise in agricultural productivity in selected crops and livestock activities. In many respects, the UNDICO unit is the spearhead of agricultural modernization in the Banco Nacional. The issue is whether their current use in the Banco is cost effective. One way to test this would be to investigate the agricultural portfolio of the recently created

private banks, which allegedly are also financing non-traditional agricultural exports. If their agricultural portfolios are roughly comparable, one could compare the relative costs per color lent for the BID-financed Banco Nacional clients and those in the private banks.

In so doing, however, care must be taken to determine if the BID effort is largely directed towards bringing small farmers into the modern investment portfolio (with all the associated technical assistance needed for that effort), while the private banks may be only financing those who have already graduated a long time ago or never were traditional small farmers in the Costa Rican sense (i.e. such as foreign nationals operating in Costa Rica). In short, the BID effort in UNDICO may be assuming a far more challenging task of modernizing a riskier and more difficult subset of farmers than the private banks, thereby justifying a higher cost of technical assistance.

5. Targeting: Credit guidelines have been simplified and partially liberalized from five years ago. Branch managers and delegados greatly prefer the current, more liberalized environment, with minimal targeting. Nevertheless, the Central Office still establishes targeted short- and long-run credit lines. It is not clear who is responsible for establishing these relative allocations and what justification or criteria is used to determine them. The operational criteria and arguments used to defend these "relative" allocations should be made more

explicit, while responsibility for making these decision should be clearly assigned.

6. Rescheduling: The rescheduling and postponement of loan repayments are fairly common in the Juntas Rurales. In some settings they could add substantially to an upper threshold of arrears. Clearly, a more detailed investigation of these reschedulings and postponements is called for, in order to determine the degree of careful evaluation behind these actions and the degree to which they may lead to further arrears later on.

7. Arrears: Striking differences exist with respect to the arrears rate among the branches in the Banco Nacional. It would be in the interest of the Bank to document these on a regular basis and to establish the regional, enterprise, and loan characteristics associated with the differential profile of arrears in the network.

For example, Palmar Norte, Carmona, Bagaces, Esparta, Filadelfia, Abangares, and Orotina have arrears rates over 90 percent in their agricultural portfolios. On the other hand, branches such as Heredia, Turrialba, Alajuela, and San Isidro only record delinquency rates in the 30 percent range, while Grecia, Palmares, Atenas, Tarazú, and Zarcero record arrears around 20 percent or less. Regional, enterprise and loan characteristics can no doubt be established here, that could help in the design of future credit strategies and in accumulating loan-evaluation intelligence information.

8. The overall arrears rate for the Banco Nacional (90 days or more) was 21 percent in 1983, 36 percent in 1985, and 37 percent in 1987. It was the state-owned bank with the highest arrears rate in 1985 and there is no reason to suppose that this changed in 1987. Within the Bank, agriculture is a highly delinquent portfolio. In 1987, 43 percent of the agricultural portfolio was in arrears (90 days or more) as was 46 percent of the livestock portfolio. In contrast, the industrial portfolio recorded a 24 percent arrears rate and the rest of the portfolio together only 21 percent. Clearly, the institution is not viable in the conventional sense of the term. Much of its current portfolio is non-performing, separate from the Juntas Rurales small-farmer area. Indeed, there is no noticeable difference between the two portfolios. On the whole, the Juntas Rurales may be performing better than the rest of the agricultural portfolio.

9. Rationing: The rigor and selectivity behind loan evaluation in the Juntas Rurales varies by branch, according to the background and skill of the delegado and his relative influence in the branch. Much rationing occurs at the "counter," when many prospective clients are screened out through casual conversation. The number of rejections within the set that fills out the forms is not particularly high in the branches we

visited. This seems to be the case elsewhere, as well. The standard time spent on processing production loans (3 to 4 weeks) or investment loans (7 to 8 weeks) is similar regardless of enterprise type. The farmer has to visit the bank a minimum of four times for an ordinary loan. The fiador (cosigner) has to visit the bank on two occasions for an ordinary loan, with the borrower paying for these expenses. These transactions costs appear to be fairly uniform, in an absolute basis, across the three branches we visited, but may differ in relative terms because of differences in loan size.

10. Old Borrowers: Perhaps the most surprising finding in the field was that former borrowers in good standing still have to fill out the same set of forms and update and document their collateral all over again as if they were a new borrower. This can even happen to an established customer applying for two loans in the same year (one for planting, the other for harvest needs). Such undifferentiated treatment between established and new borrowers appears illogical and unnecessary. It clearly adds more lending costs to the institution than is necessary as well as unnecessary borrowing costs for the established borrower.

11. Delegados: The delegado (and his two auxiliaries) are usually in the field four days of the week and in the office one day, usually Friday. The number of loans made in a year could range from 400 to 700 at a minimum, depending on the

availability of credit from the central office. There are a large number of visits in the field, numbering several thousand visits in a year. The auxiliaries usually engage in 15 to 20 minute visits per farm to check on whether corn is being grown, etc. while the delegado spends more time (and records less visits), usually checking value of collateral and providing occasional technical assistance. The delegados we visited felt that a new loan portfolio much beyond 400 clientele would be difficult to service well. It would appear that most have been induced into expanding their portfolios beyond the levels they feel they can service adequately.

12. Branch Managers: There are three separate organizations dealing with agricultural credit in the Banco Nacional. First, there are the Juntas Rurales, dealing largely with small farmer credit in traditional crop and livestock activities. Second, there is the commercial portfolio for larger operators, presumably more modern and with larger-sized loans at market rates of interest. Finally, there are the BID loans for longer-term investments in non-traditional activities. The clientele, documentation, administrative procedures and reporting requirements are different in each case. At the same time, there have been mutually designed responsibilities at the branch level, with the delegado administering the Junta Rural (and also playing an important role in administering the agricultural component of the commercial portfolio with the branch manager). The branch

manager is responsible for the rest of the portfolio (i.e. the non-agricultural loans). The lines of authority can vary. The strength of the personalities, background experience, and relative importance of the agricultural portfolio play a role in determining which of the two officials dominates decision-making for agricultural loans at the branch level.

13. Reorganization: An administrative reorganization is currently under consideration, in order to deal with the issues described in the previous paragraph. Ten regional offices would be established. Each office would have their own service units (such as BID-type technical assistance teams) to service the branches under their jurisdiction.

One credit committee would operate within each region and, at the branch level, everyone, including the delegado, would now report to the branch manager. This would create a unified mandate and executive control at the branch level. The balance between consolidation (especially of service units) and decentralization of decision-making (especially on loan evaluation and loan approval and/or rejection) is still unclear in these plans. There would appear to be a tendency to centralize decision making on the loan portfolio at levels above the branch level (i.e. in the ten regional officers). However, as of this writing (March 1988), information on the plans for reorganization is still incomplete. Thus, it is difficult to draw any firm conclusions on this effort.1/

II. Important Issues and Preliminary Recommendations

Much of what follows highlights issues concerning the current organizational framework. In addition, some issues are set forth concerning the prospective reorganization plans. The discussion is organized into two broad areas: one dealing with organizational issues (and their implicit transactions cost dimension) and pricing issues.

A. Organizational Issues

1. An important issue at the branch level is the degree to which the current case load is too burdensome for the delegado and his auxiliaries. A portfolio of 400 to 800 new loans and several thousand farm visits per year for the team raise questions about the appropriate administrative responsibility (i.,e. the most cost effective case load) to achieve a reasonable level of loan monitoring and loan recovery. The case load for the delegado and his auxiliaries frequently includes the commercial portfolio (for agricultural loans) as well as the more numerous small farmer loans in the Junta Rural. There is an implicit trade off between level of case load and rate of arrears. It is not clear if this is taken into consideration in designing the current case loads at the branch level. Informal comments suggest that the ideal case load is less than the number currently serviced at this level.

2. The issue of technical assistance is important throughout the Banco Nacional. First what degree and level of technical assistance should be carried out at the branch level and what degree at other levels? Should the bank continue to invest in building up its own technical assistance capacity (such as the BID loan teams) or should this role be contracted out to independent specialists in the private market, with an appropriate margin built into the investment loan contract to cover these project expenses? What is the optimal balance between these two possible sources of technical assistance? It would be important to investigate the cost effectiveness of the current technical assistance framework within the bank before drawing conclusions on this. In the meantime, the idea of consolidating the more intensive form of technical assistance activity into ten regional teams would appear to gain some valuable scale economies for the system. The local delegado would be performing a marginal, quick inspection role and call in the regional teams for more heavy duty technical advise.

One possible alternative in the technical assistance scenario would be to let the market determine the eventual allocation of these functions between inside and outside sources. Presumably the farmer-investor could choose to budget for outside technical assistance in his loan contract or draw upon inside bank teams. If the inside assistance is offered cost free, then the margin for contracting outside assistance would have to be cost free to the farmer (i.e. the margin is covered by the government or the donors).

3. Farm budget models (Avíos): The important issues here are whether the cost data and income data are accurate and up to date; whether the future income streams consider the probabilistic risk of bad weather and poor harvests; and the degree to which more self-finance (than is currently practiced) is feasible in the present environment. Since the avíos are widely used, their accuracy and reliability is an important issue. The assumption that farmer-investors are generally unable to engage in any meaningful level of self-finance is troublesome. This needs to be investigated more fully and a possible differential pricing scheme considered (to be discussed shortly).

4. Transactions Costs: Several important issues emerge here. Why do farmers have to visit the office 4 to 5 times for an ordinary loan (and their cosigners on two occasions?). Why do established borrowers with a good repayment record have to fill out the same forms and go through the same procedures as a new borrower? Why do two separate loans (with their associated transactions costs) have to be issued in one year (one for planting, another for harvest expenses) instead of just one loan? Is it advisable to apply the 25 page BID package of application forms to all non-BID loans that currently use far less paperwork? What guarantee do we have that the BID portfolio performs better than the non-BID portfolio? In what way, if any, do the ad-

ministrative procedures of the BID process ensure or contribute substantially to a well-performing portfolio, at least more so than the procedures currently used for the non-BID portfolio? Before applying the BID procedures elsewhere, it would be prudent to undertake an evaluation of cost effectiveness for the BID process itself.

5. Arrears data management: It would be important to regularly and systematically disseminate intelligence data on the arrears in the Banco Nacional network, by enterprise type and by loan characteristics (term structure and loan size). With this information readily at hand, local branch managers can better evaluate the risks of local loans and higher level officials can pinpoint problem areas that deserve special attention and review. At the same time, bad debt (or poor credit rating) borrowers should be identified throughout the entire banking network.

6. Consolidation and Decentralization: This issue comes to the forefront in the current plan for regional consolidation. What degree of decentralization (i.e. loan approval and rejection) should be allowed at the branch level? What degree should be passed onto the newly conceived ten regional units, with their broad-based infrastructure of technical assistance and financial analysis? One can appreciate the value of the scale and scope economies that can be gained at the regional level (particularly with respect to evaluating larger investment projects); however,

local officials have the comparative advantage of knowing the client (and the creditworthiness) better and should be drawn into the decision-making process in an important way. One hopes that attempts at cost-reducing consolidation do not ignore these local inputs (particularly on ordinary loans).

B. Pricing Issues

The major issues here revolve around differential and variable interest rates and their possible link to self-financing strategies.

1. Interest rate subsidies are not advisable for any length of time (if at all). Why not reduce the level of the interest rate subsidy for the original client once the initial farming investment has been put in place? What possible justification could there be in continuing to offer interest rate subsidies for BID-financed or other longer-term finance once the initial infrastructure is in place?

2. Similarly, why maintain interest subsidies on ordinary production loans? One would think it is self defeating to continue to offer these subsidies year after year to the same farmer for the same enterprise. If it is generating such a poor rate of return that some subsidy is needed, then the problem lies elsewhere, not in the terms of the credit contract. These

enterprises should not be financed if the root problems (outside the realm of credit) cannot be addressed or solved.

3. Why not raise the interest rate for those who refuse to self finance any of their loan? Thus the highest interest rate would apply to those who receive 100 percent financing for their enterprise activity, with a gradual decline to lower levels for those who assume a greater role in self finance.

4. Why not reduce the debt-equity ratio (i.e. increase self financing) for successive loans to the same borrower?

5. It would be prudent to introduce a variable interest rate concept into the terms and conditions of longer-term loans to protect against the impact of future inflation on the <u>real</u> terms and conditions of the original loan. This could be done in several different ways. One could have fairly automatic adjustments each quarter, semester or year, according to changes in the general price level or the price level of the major product being financed. Or, one could have discrete moments (say once a year) when the loan term could be renegotiated. Also, one could have a sliding threshold below which readjustment would not occur but above which either automatic or renegotiated settlements would occur.

These variable interest rate adjustments would likely apply to the relatively better-off farmers comprising the BID-financed portfolio or the commercial portfolio in the Banco Nacional. They would presumably be in a position to adjust to the new terms and conditions for their long-term loans, especially if the price index of the products being financed are used as a basis for readjustment.

C. Conclusions

In conclusion, the above mentioned organizational and pricing issues need to be addressed. In doing so, it should be remembered that the success of any cost-saving or risk-reducing reforms is intimately associated with the mind-set and administrative bias established by higher authorities. The more that the authorities attempt to target lines of credit, heavily subsidize interest rates, remove all borrower self-finance, and introduce time-consuming administrative rules to minimize local level decision-making and responsibility, the greater the likelihood an unselective, arrears-prone portfolio will emerge through branch level operations. Any organizational reforms should recognize the positive contribution of institutional decentralization in portfolio selection, loan evaluation, and loan management decisions.

Footnotes:

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1/ See Alvaro Cedeño, "Banco Nacional de Costa Rica: Evaluación Institucional," Rural Finance Program, The Ohio State University, March 1988.